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POLITCAL EVENTS AND THE OIL MARKET

BETWEEN 1965 AND 1985

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ECON 498
9 December 1985

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TABLE OF CONTENTS

LIST OF TABLES AND FIGURES

FACTORS THAT AFFECT THE OIL MARKET

The oil market has gone through major changes in its structure over the past twenty years. The changes that have occured can be attributed to events in both the oil producing and consuming countries. Both the political and economic events that took place in the countries directly and indirectly affected the oil market. Specific types of events however seemed to be prevalent during the periods of change in the market. These events were usually a retaliation to a previous event that may or may not have had a direct effect on the oil market, but did concern the particular country.

Political unrest in a country such as a war or a change in the government through a nondemocratic means played the largest role in instigating a change. Wars affected the market both directly and indirectly. A direct consequence of a war in a oil producing country was the decrease in production by that country. Also effected were the means of transportation of oil (e.g. canals, gulfs, shipping, pipelines, etc.) which the country had control over and other countries depended on for their production. The loss of production and the increased uncertainties caused by the war usually led to an increase in prices. Another indirect effect of war was the retaliation by other countries that sometimes occurred in support or opposition to a warring country. Retaliation in the form of an embargo would further reduce supply and place upward pressure on the price of oil.

The change in the ruling party through assassination or revolution usually only had an indirect effect on the oil market, however the effect could be significant. The new policies that are innacted by the new government could affect any part of the oil market. Not only do the policies directly affect the supply, distribution, and price of oil, but it also, like war, will increase the uncertainties associated with a new government, this could lead to higher prices through speculation on the increased risks.

Changes in government policies can occur from other factors besides a change in the ruling party. As already noted, retaliation to a war or other event that a government dissapproves of could directly affect the oil market. Embargos are used as a means of retaliation against a specific country. It is normally done to reduce the supply of oil to that country, but it has been used as a means of reducing a country's revenues by refusing to purchase from that country.

Nationalization of oil concessions is another change in government policies that has a direct effect on the oil market. This allows the oil producing countries to gain control over the productionn and pricing of the oil in their country. This effectively changes the control of the oil market from the consumers (oil companies) to the producers (oil producing countries).

Another minor form of retaliation is the enactment of conservation policies by consuming countries aimed at making themselfs less dependent on foriegn oil. The plan is to reduce the demand for oil, relieving the upward pressure on oil prices. A problem with this type of policy occurs when the government limits the profits earned by the domestic oil companies through taxation or regulation on prices which reduces the incentive for exploration. The reduced exploration reduces the known reserves by not replacing the consumed reserves with new finds. This will lead to a long-run independence problem of oil in the country.

Exchange rates and inflation are economic factors, but because of their significance in effecting political decisions they can be considered political events. Exchange rates would be of less importance if the price of a barrel of oil was based on a standard monetary unit, but because it is based on the U.S. dollar the state of the U.S. economy becomes a factor in the price. This causes concern among oil producing countries, for not only does the value of the dollar fluctuate against other currencies but it is a factor that the oil producing countries have very little control over. The control that the countries do have is counter productive from their view. For their only means of control to increase the value of the dollar, is to reduce the price of oil so as to strengthen the U.S. economy.

Inflation has constantly reduced any real gain in the price of oil that the oil producing countries have implemented. Since inflation has seemed to be a constant factor that was influenced negatively by any increase in prices that were made, inflation never appeared to be a major concern of the oil producing countries in any of the decisions that they made.

SIGNIFICANT PERIODS IN THE OIL MARKET

The factors just outlined have appeared in many forms and combinations over the last two decades. The interaction between these factors have caused oil prices to change dramatically over short periods of time. But no change in the price or supply of oil appears to have just happened with no underlying cause. Supply and demand theory can be used to explain why things happened in the oil market the way they did, but it can not explain why the events that occurred in the first place to cause the change. The political events that did occur were for the most part uncontrollable by forces outside of a particular country, but their effect on matters that concerned the whole world are of importance.

The overview of the past twenty years can be viewed as five periods of price change or stability. From 1965-1969 prices remained relatively constant. From 1970-1974 The world felt the first major increase in oil prices. From 1975-1978 a period of relative calm occurred. From 1979-1981 prices jumped dramatically for the second time. And from 1982-1985 prices have made a correction for the past increase. By looking at the events that occurred during these time periods, a correlation between the changes in the oil market and the political events that took place should be revealed.

1965-1969

Up and through this period , the oil industry was dominated by the oil companies. Complete control over production and pricing policies were decided by the oil companies. In 1960 a group of oil producing countries formed OPEC (Organization of Petroleum Exporting Countries) in an attempt to develope unity among the countries when dealing with outside forces. OPEC "declared that the price reductions should be rescinded and future changes in prices should be effected in consultation with individual governments."[1] But the succes of this group to carry out any of their declarations was very limited at this time. These circumstances meant relative stablility for the oil market.

There were few events that occurred in the period that affected the oil industry. Even when an event did occur, such as the third Arab-Israeli war, nothing significant occurred. There was an attempt to impose an embargo against France, but because of the ineffectiveness of OPEC and the control by the oil companies, the embargo was unsuccessful.

The oil companies' ability to impose total control over the oil industry meant total stability. Nominal prices remained constant while there was only a minor loss in real price caused by inflation. Production and reserves increased at a steady rate keeping in stride with increases in demand. Prices however were in reality artificially low, which lead to the changes that occurred during the next period.

1970-1974

This was the first period of real change in the structure of the oil market. Up to this point OPEC was very ineffective in controlling any aspect of the oil market. The change started in September of 1969 when "King Idris of Libya was overthrown in a military coup led by Col. Moamer Qadafi".[2] Because of Qadafi's hard line policies that he implemented he was able to lead Libya to a position of dominance in OPEC. Libya was the first country to go against the oil companies and implement a price increase and also raise taxes and be successful. A few months later the rest of OPEC followed with the same increases in the historic Tehran agreement. The Tehran Agreement "introduced the principle that their governments were codeterminants, with the oil companies, of the prices of crude oil."[3] This was the first time that OPEC acted with any authority and cooperation, which lent to their credibility. There were also announcements made by them of retaliation that they would take against any country that refused to honor the new policies that they passed.

For OPEC the oil companies posed the greatest threat to their new found power. So once again behind the leadership of Moamer Qadafi the OPEC nations began to nationalize their oil concessions. The General Participation Agreement that was signed in December of 1972 allowed "the governments to aquire a majority interest in the concessions of their operating companies over a period of ten years."[4] This not only increased the control of the production and pricing of oil that the oil producing countries had, but it also eliminated the power that the oil companies had concerning these matters. The unity that OPEC showed in these acts were significant in building their credibility as an organization that had to be dealt with.

The Yom Kippur war which began on October 6, 1973 was OPEC's first chance to prove that it now controlled the oil market. In direct retaliation to the war, OPEC increased oil prices and decreased oil production. It also felt that the U.S. and the Netherlands were directly responsible for Israel's actions since the U.S. a year earlier had agreed to supply Israel with jet fighting aircraft, and so imposed an oil embargo on those nations. Unlike the first embargo that OPEC attempted, this embargo was successful because of the decrease in production. Since production decreased the U.S. and the Netherlands were unable to obtain additional supplies of oil through indirect sources. Had the politcal events not occurred earlier in the decade, OPEC would not have had the control, credibility and unity it needed to be effective.

Another major concern was the falling U.S. dollar. Even with the gains in prices imposed earlier in the period, the fall in the dollar was reducing the real profits earned to a point where the gains were almost insignificant. This was the subject that was discussed in the Geneva Devaluation Agreement in January 1972 and the Supplemental Agreement in June 1973. These agreements called for increases in the price of oil to offset the lose in value felt by the decrease in the exchange rate of the U.S. dollar.

The increase in power of the OPEC nations meant a steady rise in prices up to the Yom Kippur War at which point oil was turned into a diplomatic tool to try and achieve the goals that the oil producing countries wanted to obtain. None of these increases could have been obtained had OPEC not obtained the increased power and control that it had .

1975-1978

OPEC had let the world know that it was now a real entity that must be dealt with when it came to oil policies. With oil prices at an all time high contentment seemed to be the attitude of all nations during this period. Even the U.S. dollar was working in OPEC's favor as it began to rise as the U.S. economy began to pickup after the recession of 1974-1975. The only significant factor affecting prices was the inflation rate, but even that could not eliminate all of the gains in prices that were made in the earlier period.

One event did occur that when looked at directly would seem to not have that significant of an effect on the oil market, but when looked at in the context of events that would occur after this date the significance appears to be important. On March 25, 1975 King Faisai of Saudi Arabia was assassinated and succeeded by King Khaled. The effect of this event was not innitially seen as the change in government appeared to have pretty much the same policies as the previous government. Only a subtle change occurred in the attitude that was taken concerning the relationship betweeen Saudi Arabia and the U.S.. After 1971 Saudi Arabia became the leading country in OPEC so that policies made by them were always significant to the oil producing countries. With Saudi Arabia as the number one oil producing country and the U.S. as the number one oil consuming country on better terms with each other this lead to some moderation in the oil market. This is not to say that all major changes were eliminated but this did keep some changes that could have occurred from occurring. This relationship may not at first be evident but through examing future events a distinct relationship seems to emerge.

Production during this period fell as consumer's demanded less oil as a result of the higher prices and were less able to afford the prices as the U.S. economy went into a recession at the beginning of the period. But as the economy began to grow and consumers accepted the increases in price, demand rose and supply followed accordingly.

1979-1981

This was the period of the second major increase in prices, but unlike the first one which was primarily the result of producers increasing prices because of internal reasons, this time it was the consumers that dictated the increase to producers as a preceived decrease in the supply of oil. The Iranian revolution was the catalyst that started all of the events that were to follow. From 1971 until the revolution in 1978, Iran had been the second leading country in OPEC. When the revolution broke out, Iran's production fell. This lead Speculators to begin bidding oil prices up on the spot market. With the official price of oil being significantly less the the spot prices of oil, oil producing countries began to sell their oil on the spot market to take advantage of the increased prices. In an attempt to maintain unity and control over the oil market OPEC continuously raised the official price of oil.

Also keeping the demand for oil at an artificially high level was the stockpiling of oil by consuming countries. In 1980 for example the U.S. had a record level of oil in inventory. This not only kept an upward pressure on the price of oil, but also upset the OPEC nations and led to threats of retaliation if the practice was not stopped.

Mid 1980 also saw the beginning of the Iran-Iraq war. This compounded the changes that occurred because of the Iranian revolution. Now not only was one country's supply reduced because of the revolution, but a second country now had a reduced production because of their involvement in the war. This war also spilled over onto the surrounding countries as there were threats to shipping in the Persian Gulf.

Even though prices continued to climb because of the speculation of shortages caused by the war in Iran and Iraq and the increase in the demand brought about by stock piling there was never a shortage of oil during this time. What had occurred was that other countries had increased their production to compensate for any loss of supply that had occurred. Most of the supply was made up by Saudi Arabia.This increase in supply by Saudi Arabia appears to be both economically and politically motivated. It was an opportunity for them to increase their share of the oil market, but it also was a way of repaying the U.S. for the increased military support that they were receiving from the U.S.. For example on September 30, 1980 the U.S. sent Saudi

Arabia four sophisticated surveillance planes to help Suadi Arabia moniter the Iran-Iraq war. As a result of Saudi Arabia accepting the planes, Qadafi, of Libya, announced to "all Muslims that they should forgo the annual religious pilgrimage to Mecca because all of Saudi Arabia, including Islam's most sacred shrines, was 'under U.S. occupation.'"[5] Saudi Arabia felt that this was a slur on their "guardianship of Islamic holy places" and so cut its ties with Libya. On May 26,1981 at a meeting of OPEC nations Suadi Arabia refused to raise their price or decrease their production of oil, which led to other OPEC countries placing a freeze on prices and lowering their outputs.[6] Then finally on October 1, 1981 President Reagan said the U.S. would not allow Saudi Arabia to fall under the control of forces threatening to cut off oil supplies to the west.[7]

The U.S. at this time also began to take an active role in trying to reduce their dependency on foreign oil. It imposed an import fee on foreign oil, but then levied a windfall profits tax on the oil companies. Oil imports did fall along with demand but it would appear that the cause of the decrease was more the increase in the price of oil then the actions that were taken. The windfall profit tax actually had negative effects on the dependency issue as it made exploration less desirable as the money available for this type of undertaking became less.

Oil prices rose dramatically during this period and remained high because of the uncertainties. The exchange rate of the U.S dollar hit an all time low which somewhat moderated the increase in price. It was also a period in which demand increased faster then supply, but the demand was not needed demand so that there were no real shortages.

Even with the large increases in the price, it was becoming apparent that OPEC was beginning to loose the control over the oil market that it had earlier in the decade. Price increases were no longer the result of OPEC nations declaring an increase in price but rather the speculators on the oil market bidding up the price of oil based on a believed shortage that never occurred. Since the increase in prices were not caused by a real increase in demand it should have been obvious that the prices could not be maintained, which they were not as seen in the next period.

1982-1985

This last period appears to be one of correction for the previous period. Prices were at an artificially high level so when it became apparent that the supply of oil would not decrease as drastically as originally expected and that the demand for oil had been significantly reduced because of the high prices, the upward pressure on oil prices was removed. With the lower demand for oil and the increased fear of dealing with OPEC nations because of the unrest in the Arab countries nations began to depend less upon OPEC for their oil. This increased the number of countries that had a share in the oil market and reduced some of the importance of OPEC in controlling the market. The effect on the OPEC nations was great in that they had become use to the large incomes in the past few years and were now faced with reduced revenues as the amount of oil that they could sell became less. This led to some OPEC nations under cutting the official price as a means of boosting the demand for their oil. This cycle continued until the official price of oil fell and production quotas were imposed but were ignored.

With the return of the buyers market, consuming countries now had some control. The U.S., starting on March 10, 1982, was able to mount a successful oil embargo against Libya as a means of protesting the alleged terrorism that Libya was supporting. Libya had been selling two billion dollars worth of oil a year to the U.S., which was one-forth of their total production. Both Libya and Iran were facing financial problems that lead to unrest among the OPEC countries, with Saudi Arabia being accused of taking more than their fare share of the market. This lead to a drop in the production quotas on December 20,1982 as Iran challenged Saudi Arabia's control over OPEC.[8]

On March 14, 1983 OPEC was forced to reduce the official selling price of their oil by five dollars a barrel to twenty-nine dollars in an attempt to end the cutthroat pricing and to try and restore an equilibrium. But with the demand for oil down and the economic pressures on certain OPEC members, the price war continued and a further cut in prrices occurred in February of 1984.

A fake glut of the oil market appeared, but in reality the glut was not there. What has occured was that with the shift in demand from the OPEC nations to other nations, and only a small reduction in production by OPEC nations there was a temporary over supply of oil on the market. What has happened is that non OPEC nations have had to increase their production rate to point higher then in the past, so that even though short-term problems are covered the long-run solution is not taken care of.

Also since 1981 the U.S. dollar has continued to gain in strength to where in 1983 prices received by the oil producing countries actually rose due to the higher dollar, while the U.S. consumer price fell because of the rise. Therefor it would seem that there has been no pressure on the price of oil to cause it to rise.

The threat of Price and Production control by the OPEC countries has gone into submission with many wondering wether they can ever be a viable force again. It would appear though that as the third world countries begin to develope and increase theit demand for oil OPEC will have a new source of revenue. The other oil producing countries will have to supply a greater share of their own source of oil and so exports from these countries to the developing countries will be limited at best. OPEC will only have a limited control over the third world countries, because unlike the developed countries that they had been dealing with in the past that could absorb the higher prices, the developing countries cannot. This should mean a more moderate pricing policy by the OPEC countries.

EVOLUTION OF CRUDE OIL POSTED OR TAX-REFERENCE PRICES AND OFFICIAL SELLING PRICES FOR ARABIAN LIGHT 34 AT RAS TANURA, SAUSI ARABIA 1948 - 1982 (U.S. DOLLAR PER BARREL)

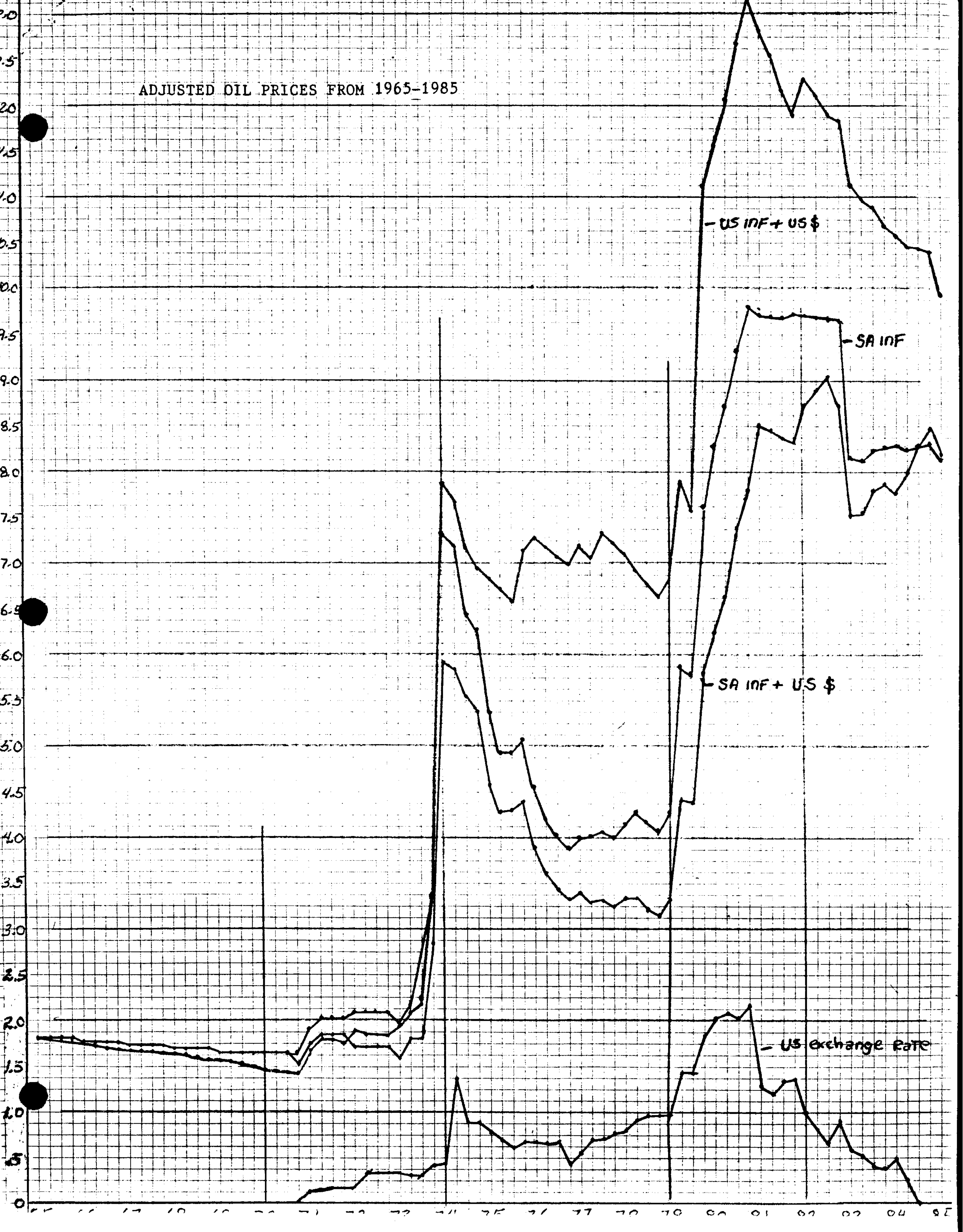
YEAR AND MONTH		POSTED OR TAX-REFERENCE PRICES	OFFICIAL SELLING PRICE
1948	APRIL	2.18	----@
	JULY	2.03	----
1949	APRIL	1.84	----
	OCTOBER	1.71	----
1953	FEBRUARY	1.93	----
1957	JUNE	2.08	----
1959	FEBRUARY	1.90	----
1960	AUGUST	1.80	----
1971	FEBRUARY	2.18	----
	JUNE	2.29	----
1972	JANUARY	2.48	----
1973	JANUARY	2.60	----
	APRIL	2.74	----
	JUNE	2.90	----
	JULY	2.96	----
	AUGUST	3.07	----
	OCTOBER 1	3.01	----
	OCTOBER 16	5.12	----
	NOVEMBER 1	5.18	----
	DECEMBER 1	5.04	----

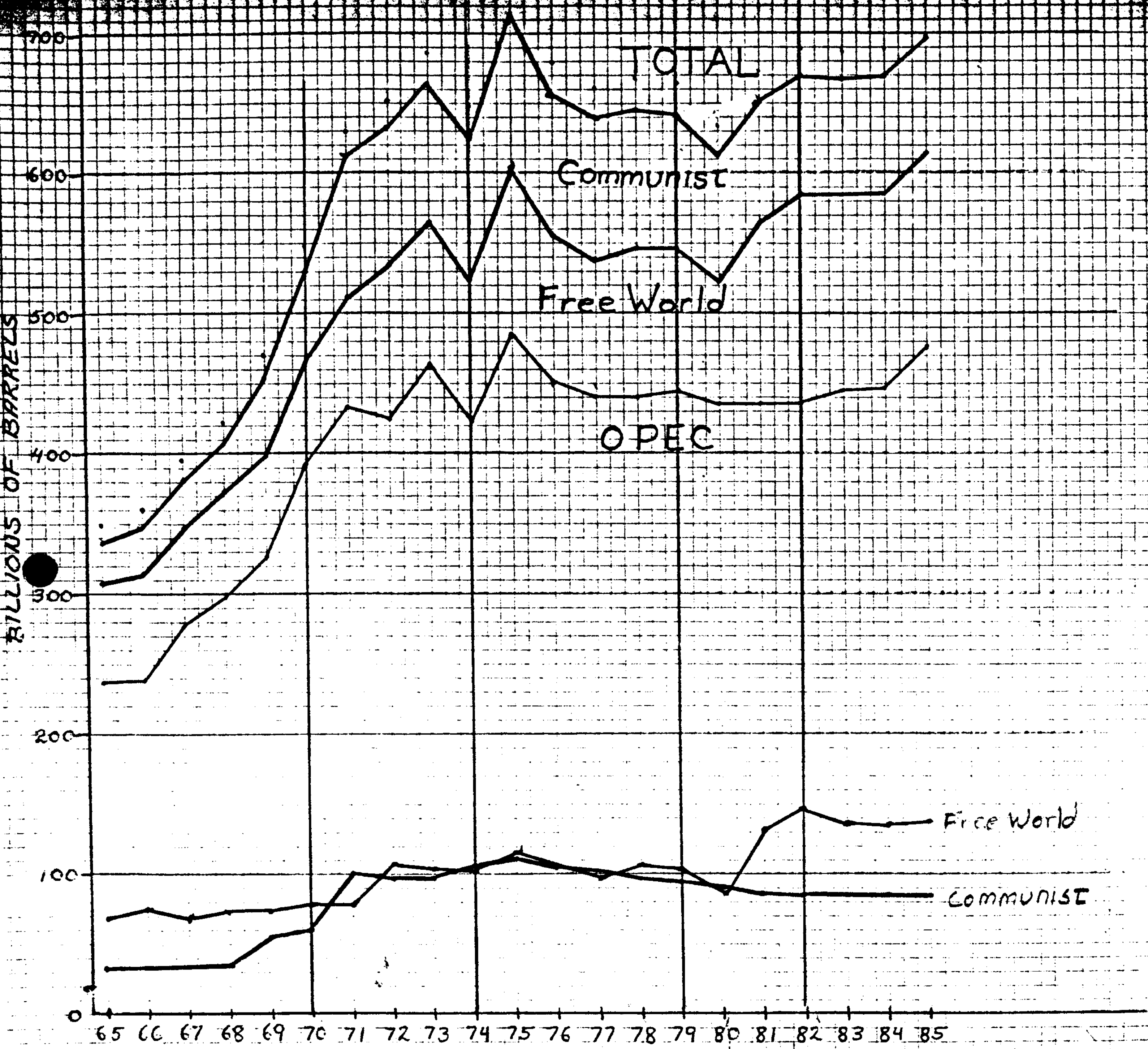
1974	JANUARY	11.65	----
	NOVEMBER	11.25	10.46
1975	OCTOBER	12.38	11.51
1977	JANUARY	13.00	12.09
	JULY	13.67	12.70
1979	JANUARY	14.34	13.34
	APRIL	15.46	14.55
	AUGUST	19.36	18.00
	NOVEMBER	25.81	24.00
1980	JANUARY	27.96	26.00
	APRIL	30.11	28.00
	AUGUST	32.26	30.00
	NOVEMBER	34.41	32.00
1981	JANUARY	34.41	32.00
1982	JANUARY	34.00	34.00
1983	MARCH	----	29.00
1985	FEBRUARY	----	28.00

SOURCES: OPEC, Annual Statistical Bulletin 1980. pp 135-37; U.N. Economic Commission for Europe, The Price of Oil in Western Europe, Neil H. Jacoby, Multinational Oil (New York: Macmillan Co., 1974)

NOTES: Posted price for Arabian Light has been used by OPEC member countries as the benchmark price for the crude-oil price structure. The official selling price charged by any memberr country - including Saudi Arabia.

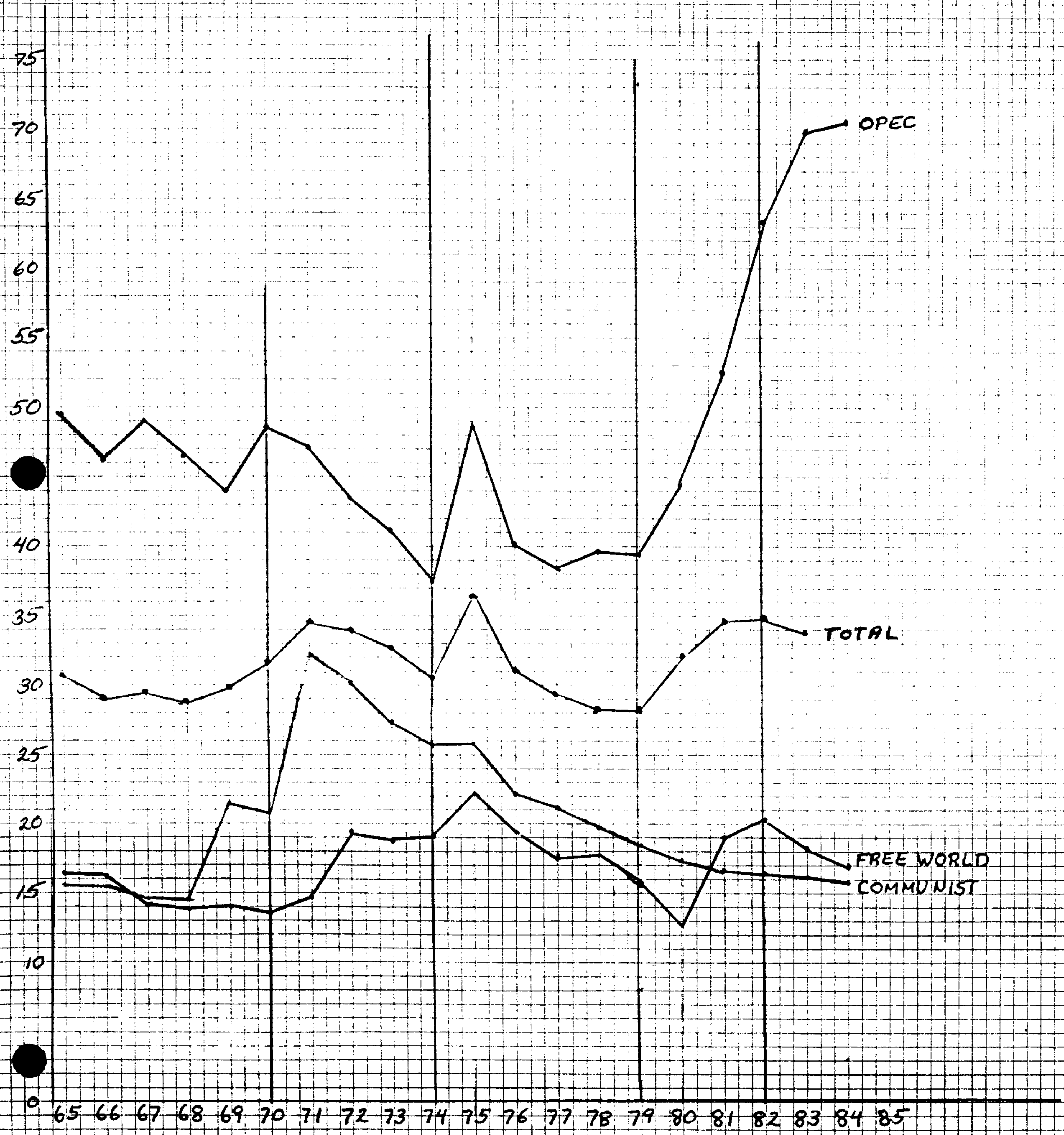
@ Dash denotes no official government selling prices


ADJUSTED OIL PRICES FROM 1965-1985
US INF + US $
SA INF
SA INF + US $
US exchange rate

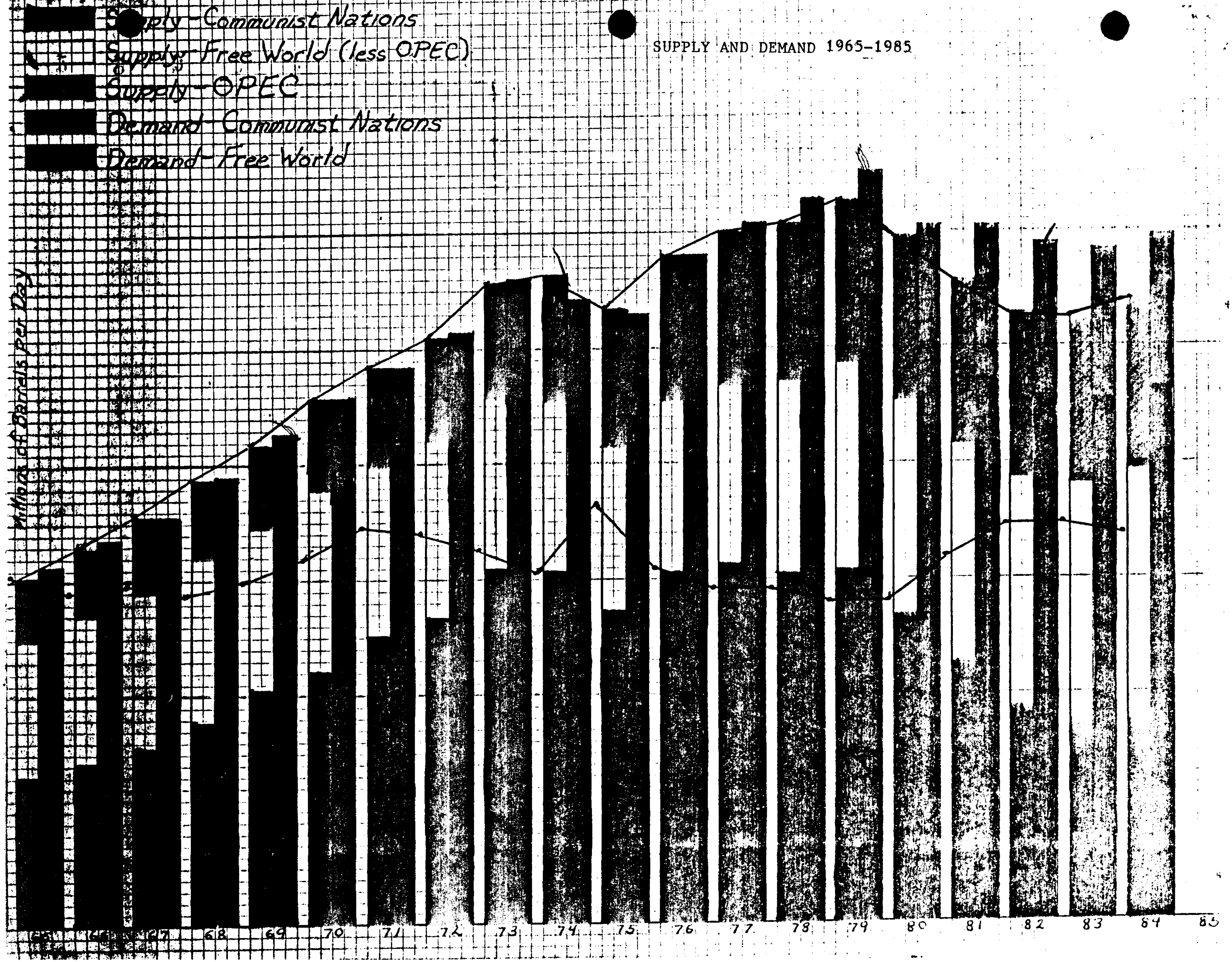


Estimated Known Reserves

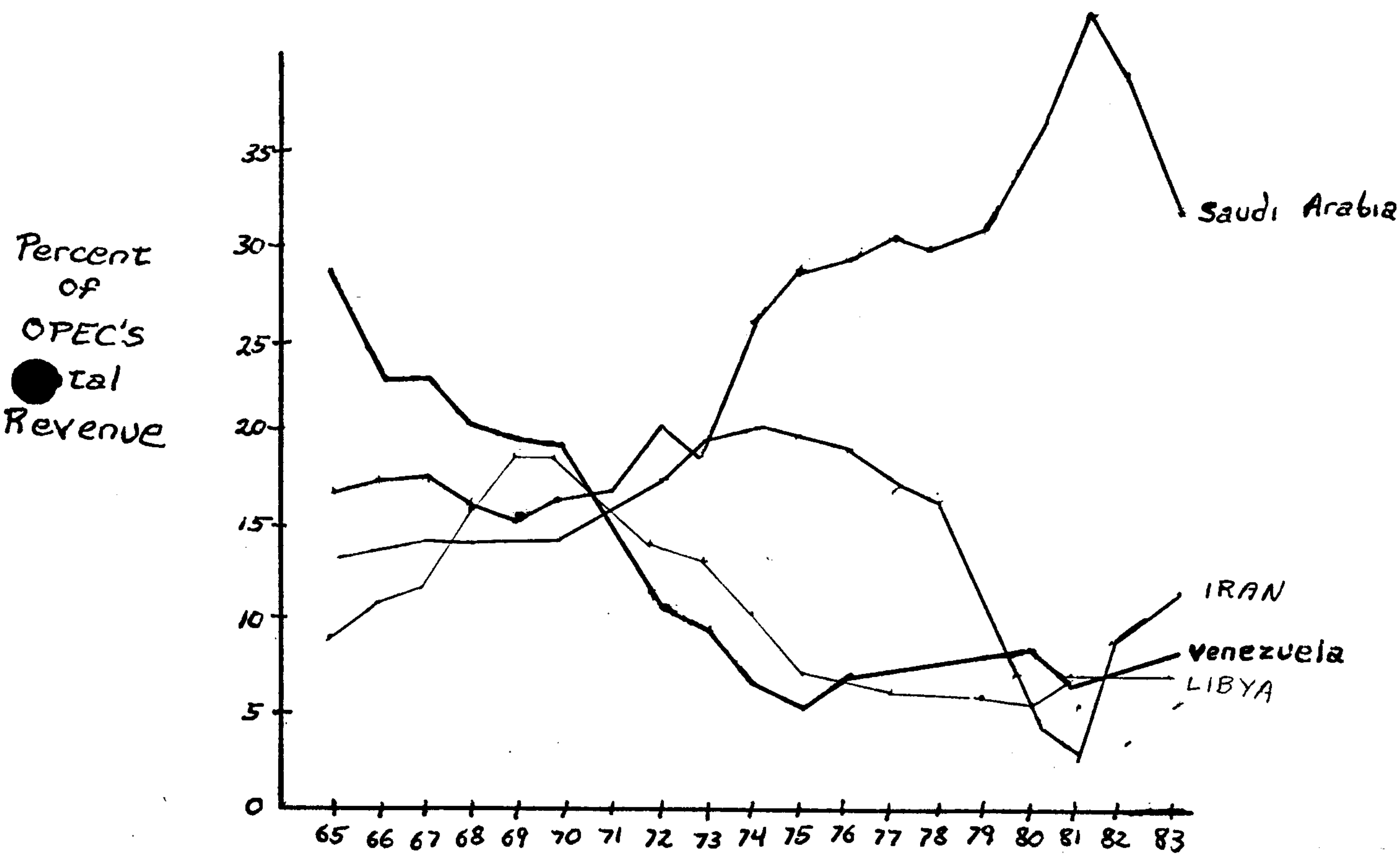
RESERVE/SUPPLY RATIOS 1965-1985



SUPPLY AND DEMAND 1965-1985



PERCENT OF OPEC'S REVENUES PER COUNTRY



NOTES

[1] Alnasrawi, Abbas, OPEC in the Changing World Economy. (Baltimore: The John Hopkins University Press, 1985.), p.

[2] Grun, Bernard, The Timetables of History. (New York: Simon and Schuster, 1975.) p.636

[3] Alnasrawi, p.

[4] Alnasrawi, p.

[5] Britannica Book of the Year. (Chicago: Encyclopedia Britannica, Inc., 1981.), p.47

[6] Collier's Year Book. (New York: Macmillan Educational Company, 1982.), p.601

[7] Collier's Year Book, p.603

[8] Britannica Book of the Year. (Chicago: Encyclopedia Britannica, Inc., 1983.), p.

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